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TAGS: EFIN ECON EINV SR
SUBJECT: SERBIA: ECONOMIC NUMBERS POINT TO RISKS AHEAD

REF: Belgrade 1061

Summary

¶1. According to third quarter data for 2007, industrial production in Serbia continues steady growth of 5% annually, GDP growth of 7% is expected, strong export expansion continues, while import growth slowed slightly. The growing current account deficit as a result of the trade deficit and credit expansion is unsustainable in the long term and was described by Stojan Stamenkovic of the Economics Institute as, "a bomb that we are sitting on." Inflation, as a result of booming public consumption and price pressure on basic food products, could reach 9.3% this year versus earlier projections of 6.5%. The dinar appreciated against the euro due to restrictive monetary policy and strong inflow of foreign capital, reaching its highest level since October 2004. End Summary.

First Half 2007 GDP Growth 8%

¶2. GDP growth driven by the services sector in the first half of 2007 reached 8%, while it is expected to slow down and to be 7% cumulative for all of 2007. Overall industrial production grew by 4.7% in the first 9 months of 2007 compared to the same period in 2006 and is expected to reach 5% growth for the whole ¶2007. The strongest areas of growth were: food processing, electricity production, machinery and appliance production, and basic metals production.

Expansionary Fiscal Policy Threatens Macroeconomic Stability
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¶3. The government generated revenues of $7.68 billion in the first nine months of 2007, which represented a 10% increase in real terms over the same period in ¶2006. The increase came mostly from increased consumption (including imports) - improved collection of the VAT (17%), excise taxes (9.5%) and customs revenues (19%). Budget expenditures reached $7 billion in the first nine months, and were up 9% in real terms over the same period 2006. The largest

public expenditure item was the public wage bill of $1.95 billion, up 12% in real terms over the same period 2006. Despite the current budget surplus of $672.7 million - from which under IMF methodology one must also exclude one-time revenue from the sale of a mobile telephone license of $455 million - the expansionary fiscal policy threatens macroeconomic stability by triggering higher than expected inflation, forcing the Central Bank to impose more restrictions in the monetary sector.

Monetary Policy Tightening - Restriction on Credit Length
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¶4. In an effort to slow down the inflation and inflationary pressures, the National Bank of Serbia (NBS) increased the reference interest rate at the end of August by 0.25% to 9.75% annually, but then reversed course and moved it back to 9.5% on October
¶29. The NBS also withdrew a total of $618 million through repossessing operations in the third quarter of 2007 thus increasing the stock of sold securities to $3.4 billion at the end of September 2007 - up by 23% over December 31, 2006. As a result of expansionary fiscal policy and increased salaries, strong credit expansion continues - the value of loans approved during the whole of 2006 has been exceeded in just the first seven months of 2007. In order to slow down credit expansion, especially loans to individuals, the NBS adopted a number of measures at the end of August. The least popular of these was the

limitation of the repayment period for cash loans to two years. These measures yielded results and September credit growth was only $145 million, compared to average January-August 2007 monthly growth of $365 million.

¶5. Citizens' confidence in the banking sector has grown rapidly and hard currency savings reached $6.2 billion at the end of September from nearly zero in
¶2000. However, confidence in the dinar is low after hyperinflation during the 90's and dinar savings reached only $174 million at the end September.

2007 Inflation Projections Revised From 6.5 to 9.3%
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¶6. NBS efforts to keep inflation down managed to keep core inflation near the bottom of the targeted range for 2007 of 4-8%. According to NBS projections it will be 4.5% by the end of 2007. However, overall inflation, which includes administratively controlled prices, already in September had exceeded the projected level of 6.5% for the whole 2007. Finance Minister Cvetkovic revised his projection at the end of September and stated that 2007 overall inflation will be 8.5%. However, on October 9 the Economic Institute's Stamenkovic estimated that inflation would climb to 9.3% in 2007. Stamenkovic added that the major cause for inflation was increased demand caused by increased wages. The inflation situation was exacerbated by price increases for basic foods (milk, bread, cooking oil) which he attributed to increasing concentration of ownership of food processing and retail outlets, in addition to recent drought-related price increases.

Real Average Wage Up By 11%

¶7. The average net monthly wage in September reached $521, up 11% in real terms over September 2006. This

growth is almost 50% greater than the GDP growth rate, and is not balanced by corresponding productivity increases. Public sector wages again led the increase, with a monthly average of $560.

January-August Exports Up By 41%, Imports 37%, Deficit 34%

¶8. In the period from January-August 2007 the total value of exports reached $5.55 billion, an increase of 41% compared to the same period in 2006, while total imports reached $11.14 billion or up 37% from 2006. The trade deficit reached $5.59 billion, 34% greater than the same period in 2006. In euro terms the growth is somewhat less significant, as the fall in the dollar meant that in euro terms, exports grew by 31%, imports grew by 27%, while the deficit grew by 24%. Imports grew due to:

-- imports of oil and gas products which represent 17% of the total value of imports and grew by 8%;

-- imports of copper and iron ore, reaching 9.8% of total imports and grew by 78%; and due to

-- increased demand, as a result of an increase in public and personal consumption (e.g. vehicle imports grew by 52% and totaling 8% of imports).

¶9. Exports grew as a result of:

-- continuing privatization and restructuring of companies;

-- expanding trade with CEFTA countries (exports to these countries grew by 43% over 2006 and reached $1.8 billion);

-- exports of agricultural products (fruit, vegetables and wheat) which reached 10% of total exports and grew by 53%;

-- a surplus of $80 million in textile trade due to preferential treatment by the EU;

-- beneficial terms of trade - Serbia mostly exports to euro zone, but much of its imports are priced in dollars; and

-- high prices for Serbian raw materials exports.

¶10. More than half of Serbia's total trade was with EU countries. Serbia had a trade surplus with former Yugoslav republics. The largest trade deficit was with Russia, mostly due to imports of oil and gas. Key exports from January-August 2007 were:

-- iron and steel ($780 mil.),

-- non-ferrous metals ($458 mil.),

-- fruits and vegetables ($289 mil.),

-- clothes ($272 mil.), and

-- metal products ($260 mil.).

The largest imports were:

-- oil and derivatives ($1.1 billion),

-- road vehicles ($903 mil.),

-- iron and steel ($626 mil.),

-- industrial machines ($570 mil.), and

-- gas ($495 mil.).

Stamenkovic: Current Account Deficit is Unsustainable
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¶11. The current account deficit in the period January-August 2007 reached $3.76 billion or 78% up over the same period last year, mostly due to the increased trade deficit. Out of the $1.64 billion difference between 2006 and 2007, $1.28 billion represents an increase in the trade deficit. The surplus in the capital balance in January-August 2007 reached $4.67 billion, but it was 30% lower than in the same period 2006. The major contributors to the surplus were new loans of $2.42 billion. Foreign direct investment (FDI) in the period was just $1 billion compared to $3 billion in the same period
¶2006. Jasna Matic, State Secretary in the Ministry of Economy, stated on October 27 that 2007 FDI will be $2.5 billion less than in 2006 due to the lull in the privatization process earlier in the year following parliamentary elections in January and the slow formation of a new government. [Note: Serbia's net FDI figures include a $700 million deduction due to Serbian investment in Telekom Republika Srpska]. Asked how long the high current account deficit can last, Stamenkovic replied "as long as there is enough inflow in capital balance to finance this, i.e. as long as there is enough FDI." Thus, according to Stamenkovic the situation is not sustainable in the long run, and is like "a bomb we are sitting on" and could explode unexpectedly if political turbulence (such as Kosovo) slows the inflow of FDI.

Dinar Appreciation - The Highest Value since October 2004
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¶12. On October 26, 2007 the dinar reached its highest value (76.86 dinars to the euro) since October 2004. Dinar appreciation is "collateral damage" of the

current monetary policy and the lack of coordination between monetary and fiscal policies. To keep low inflation, the NBS has had to maintain high interest rates due to expansionary fiscal policy and credit expansion. Higher interest rates paid by the NBS stimulate banks to borrow cheap money abroad and to use the money locally to either buy NBS securities or lend money in Serbia at higher rates. The additional inflow of hard currency:

-- increases the value of the dinar;

-- increases hard currency reserves (generating net losses for the NBS since reserves are kept in low-yield foreign securities, while the NBS pays high interest rates on domestic securities); and

-- increases NBS losses due to increased repossessing operations which reached $545 million in 2006.

Comment

¶13. Robust economic growth and FDI have staved off threats to Serbia's economic balance over the past several years. With increased demand generated by wage increases in the run up to last January's

elections, there is increasing pressure from import growth and inflation. The current account deficit and inflation highlight the fragility of Serbia's economic engine. Serbia is dependent on FDI and foreign borrowing and as a result the economy is particularly vulnerable to political instability that slows capital inflows from abroad. While the political leadership in Belgrade is focused on their immediate political goals of maintaining Kosovo, the collateral damage to Serbia's economy could be significant if achieving these political goals comes at the cost of international investor confidence. A significant dip in international investor perception of Serbia's attractiveness would threaten economic growth. End Comment.

MUNTER